Observations and proposals by the Government of the United States of America on the text of the preliminary draft uniform rules on international financial leasing as proposed by the drafting committee at the second session of governmental experts

Rome, March 1987
OBSERVATIONS AND PROPOSALS
OF THE UNITED STATES OF AMERICA

International Institute for the
Unification of Private Law:
Draft Convention on International Financial
Leasing as Proposed by the Drafting Committee at the
Meeting of the Committee of Governmental Experts,
Second Session, 14 - 18 April, 1986, Rome, Italy

The United States of America is pleased to present to the
Secretariat of the International Institute for the Unification of
Private Law ("UNIDROIT") its observations and proposals relating
to the draft convention on International Financial Leasing as
proposed by the Drafting Committee at the Meeting of the Committee
of Governmental Experts, Second Session, 14 - 18 April, 1986, held
in Rome, Italy.

General Observations.

The most recent draft ("1986 Draft") of the UNIDROIT
convention on international financial leasing (Study LI X - Doc.
33, Appendix) has been reviewed and considered by various
interested parties in the United States under the auspices of the
Department of State. We remain of the view that the project is
worthwhile and that there exists a reasonable prospect that a
Convention will be adopted which would contribute to the growth of
international trade and the development of international private
law.

The 1986 Draft is an improvement over prior drafts in a
number of respects. It is a more refined and technically improved
product. As a matter of substance, however, the 1986 Draft
contains certain provisions which we believe are even further
removed from the real world of international financial leasing—in
particular, Article 7 (lessor's duties to lessee and third parties
and lessor's warranty of quiet enjoyment) and Article 10 (lessee's
rights as to non-conformity and non-delivery of equipment). We
are hopeful that these and certain other substantive and technical
matters will be resolved during the Third Session.
Specific Observations and Proposals.

The United States submits the following specific observations and proposals with respect to the 1986 Draft. (Proposed changes to the text of the 1986 Draft are set out below with proposed deletions indicated by square brackets and proposed additions indicated by underscoring.)

Captions: Table of Contents

We propose that explanatory captions be added to each Article and paragraph of the Convention. We also propose that a table of contents be prepared for the Convention, based on the captions. At least two useful purposes would be served by this exercise. First, it would force the Committee and others to focus more closely on the substance of what is being treated in each provision; this may improve the quality of the consideration given to the provisions. If agreement were not easily reached on a caption, it could suggest that there is some lack of clarity or other confusion as to what is intended by a substantive provision. Second, captions would facilitate the reading and interpretation of the Convention during the drafting and adoption stage as well as after the Convention were to become effective.

Attached as an appendix to these observations and proposals is a listing of suggested captions for the various Articles and paragraphs included in the 1986 Draft and for proposed new paragraphs discussed below.

Preamble - Fourth Clause.

Proposed Revised Text:

CONSCIOUS of the fact that the rules of law governing the traditional contract of hire [/are ill-suited/ /need to be adapted/ to] do not adequately take into account the distinctive triangular relationships created by the financial leasing transaction,

Discussion:

The proposed change to the fourth clause of the Preamble represents a suggested compromise between the two bracketed alternatives in the 1986 Draft.
Article 1

Paragraph 1

Proposed Revised Text:

Alternative A

1.- This Convention governs a financial leasing transaction in which one party (the lessor)

(a) enters into an agreement (the supply agreement), on the specifications of, and on terms approved by, another party (the lessee), under which the lessor acquires, by purchase or lease, goods such as [plant], capital goods or other equipment (the equipment) from a third party (the supplier) and

(b) enters into an agreement (the leasing agreement) granting to the lessee the right to the equipment [for business or professional purposes] in return for the payment of rentals.

Alternative B

1.- This Convention governs a financial leasing transaction in which one party (the lessor)

(a) enters into an agreement (the leasing agreement) granting to another party (the lessee) the right to use goods such as capital goods or other equipment (the equipment) in return for the payment of rentals and

(b) enters into an agreement (the supply agreement) with a third party (the supplier), under which the lessor, on the specifications of and on terms approved by the lessee, acquires goods from the supplier by purchase or lease.

Discussion:

Alternative A

(i) The addition of the phrase "by purchase or lease" is intended to expressly contemplate that subleases may be subject to the Convention. See also proposed new paragraph 3, infra.

(ii) The other proposed change to subparagraph (a) is intended to make it clear that the Convention only applies to goods. "Capital goods" does not connote any clear meaning in the
United States. Moreover, "plant" could be interpreted to include real property (i.e., a factory building). Therefore, we propose to delete the term "plant." See also proposed new paragraph 5, infra.

(iii) As to the proposed change to subparagraph (b), see the discussion below of proposed new paragraph 3 to Article 1.

Alternative B

Alternative B is intended to achieve exactly the same result as Alternative A. However, Alternative B has been redrafted for clarity. Paragraph 1(a) of both the 1986 Draft and our proposed Alternative A are confusing in that they refer to "another party (the lessee)" in the context of describing the supply agreement. One might improperly construe the reference to suggest that the lessee would be a party to the supply agreement.

Paragraph 2

Proposed Revised Text:

2.- The financial leasing transaction referred to in the previous paragraph is a transaction which possesses the following [main] characteristics:

Discussion:

The reference to "main" characteristics is proposed to be deleted. It adds nothing and promotes confusion. If the characteristics specified are present, the Convention should apply (assuming it would otherwise be applicable). Factual issues should not be introduced as to whether the characteristics, even though present, are "main" in a given transaction. These characteristics are necessarily "main" because they serve to distinguish the sui generis financial leasing transaction from other transactions.
Paragraph 3 (Proposed)

Proposed Revised Text:

3. - In the case of a financial leasing transaction described in paragraphs 1 and 2 in which the lessor acquires the equipment by lease from a third party and subleases the equipment to the lessee, the third party which leases the equipment to the lessor is the supplier unless the lease of the equipment to the lessor is itself a financial leasing transaction described in paragraphs 1 and 2. In the case of a series of transactions involving the same equipment which includes more than one financial leasing transaction described in paragraphs 1 and 2, the supplier of the equipment in such financial leasing transactions is the least remote seller or lessor of the equipment pursuant to a transaction which is not such a financial leasing transaction.

Discussion:

The proposed new paragraph 3 attempts to address some of the issues raised by the possibility that a financial leasing transaction intended to be covered by the Convention may be a sub-lease (or a sub-sub-lease, etc.) and the possibility that a supply agreement may be a leasing transaction rather than a sale transaction. At the April, 1986 meeting, there seemed to be a consensus of the Drafting Committee and the other participants at the meeting that these possibilities existed under the 1985 draft and the 1986 Draft rules. There are a variety of approaches to drafting which could be taken so as to treat these issues in the rules. No doubt the language proposed above could be improved upon.

Our principal observation is that the rules would be improved if they addressed the sublease and related issues directly. The proposal is an attempt to negate the result otherwise obtained under paragraph 1(a) which would always cause the lessor to a financial sublessor to be a supplier. However, if this proposal is accepted, it then becomes necessary to describe which remote party would be the supplier. The second sentence of proposed new paragraph 3 would provide that one must follow the chain of transactions "up" from the lessee until a seller or a lessor (other than a lessor pursuant to a financial leasing transaction) is identified.
Paragraph 4 (Proposed)

Proposed Revised Text:

4. - This Convention does not apply to a financial leasing transaction under which the lessee obtains the use of equipment for personal, family or household purposes, unless the lessor, at any time before or at the conclusion of the leasing agreement, neither knew nor ought to have known that the use of the equipment was being obtained by the lessee for any such purposes.

Discussion:

It is proposed that the words "for business or professional purposes" be deleted from paragraph 1(b) of Article 1. The proposed new paragraph 3 would substitute a test which would exclude only consumer transactions, with all other transactions included. The formulation of the 1966 Draft would likely lead to uncertainty and unpredictable results. For example, is a lease to a not-for-profit hospital or research organization, to an educational institution or to a governmental agency or instrumentality for a "business or professional" purpose? The proposed new paragraph 4 tracks closely the language of Article 2, clause (a), of the United Nations Convention on Contracts for the International Sale of Goods ("Sales Convention"). In addition, the drafting technique of inclusion or exclusion based on a definition of "consumer" transactions or goods, rather than a definition of "business" transactions or goods, is one which has received nearly universal acceptance in Federal and state legislation in the United States and has proved to be a satisfactory approach.

Paragraph 5 (Proposed)

Proposed Revised Text:

5. - This Convention applies to goods which have become a fixture to or incorporated in land, but this Convention does not apply to ordinary building materials incorporated into an improvement on land.

Discussion:

Article 6 contemplates that property which is the subject of a leasing transaction may "become a fixture to or incorporated in land." We believe that Article 1 should be modified, as proposed in new paragraph 5, so as to expressly state what is so
contemplated by Article 6. However, we also propose that goods which are "ordinary building materials" such as bricks and mortar be expressly excluded from coverage by the Convention. The reference to "ordinary building materials" is borrowed from U.C.C. § 9-313(2).

It should be emphasized that under Article 6 the question of whether goods have become fixtures and the rights as between a lessor and a landowner are left to the law of the State where the land is situated and are not governed by the Convention.

Article 2

Paragraph 1

Proposed Revised Text:

(b) the rules of private international law (including any effect given, under such rules, to a selection of applicable law by the parties to the supply agreement or the parties to the leasing agreement) lead to the application of the law of a Contracting State to the supply agreement and lead to the application of the law of a Contracting State to the leasing agreement.

Discussion:

The proposed change to paragraph 1(b) is drawn in part from Article 1, paragraph (1)(b) of the Sales Convention. It also serves to avoid a construction resulting in application of the Convention only where the supply agreement and the leasing agreement expressly designate the law of a Contracting State. It should be noted, however, that Sales Convention paragraph (1)(b) proved to be controversial and received special treatment in the Final Provisions of the Sales Convention which permit a Contracting State to elect not to be bound by Sales Convention paragraph (1)(b). Indeed, the United States has so chosen not to be bound by Sales Convention paragraph (1)(b). Therefore, we reasonably might take the position that paragraph 1(b) should be deleted entirely from the leasing Convention. However, a more practical approach would be to suggest that, if paragraph 1(b) is to remain, it should follow to some extent the language and style of Sales Convention paragraph (1)(b). Our proposal also attempts to make it more clear that the law applicable to the supply agreement and the law applicable to the leasing agreement need not be the law of the same Contracting State.
Paragraphs 3 and 4 (Proposed)

Proposed Revised Text:

3.- The fact that the lessor and the lessee have their places of business in different States is to be disregarded whenever this fact does not appear either from the leasing agreement or from any dealings between the lessor and the lessee, or from information disclosed by the lessor or the lessee, at any time before or at the conclusion of the leasing agreement.

4.- Neither the nationality of the lessor or the lessee nor the civil or commercial character of the lessor or the lessee or of the leasing agreement or the supply agreement is to be taken into consideration in determining the application of this Convention.

Discussion:

Proposed new paragraphs 3 and 4 are derived substantially from Article 1, paragraphs (2) and (3) of the Sales Convention. They would appear to be useful here for the same reasons that led to their inclusion in the Sales Convention. Additionally, we believe that the UNIDROIT reports and any official or unofficial commentary on the Convention should explain and elaborate upon the purpose of proposed new paragraph 4 (i.e., to make clear that certain distinctions applicable in some civil law States are not relevant to the Convention). Otherwise, that purpose might not be apparent to many lawyers and businesspersons in the United States and other common law countries.

Article 3

Proposed Revised Text:

This Convention applies whether or not the lessee has or acquires the right or obligation to buy the equipment or to hold it on lease for a further period.

Discussion:

It is proposed that the words "or obligation" be inserted in the second line of Article 3. This change would result in the application of the Convention to a transaction where the lessee is obligated to become the owner of the equipment at some point. Although such express contractual obligations are somewhat unusual, many transactions intended to be subject to the
Convention may contain terms which, in effect, require the lessee to become the owner out of economic necessity (i.e., nominal purchase options). As written, Article 3 might be construed to apply only to transactions where such economic compulsion does not exist.

Article 4

Proposed Revised Text:

[1.-] The supply agreement may not be varied without the consent of the lessee and the lessor.

[2.- The specifications given by the lessee to the supplier may not be varied without the consent of the lessor.]

Discussion:

Paragraph 2, as drafted, creates several problems. First, it is not necessarily the case that the specifications provided by the lessee will be "given by the lessee to the supplier." The lessor, rather than the lessee, may provide such specifications to the supplier after receiving them from the lessee. Second, it is not clear how the lessee can affect the terms of the supply agreement (such as the specifications) in any event, since the lessee will not be a party to the supply agreement. In effect, paragraph 1 alone should be sufficient. Third, and related to the second point, the implication of paragraph 2 may be that somehow the lessee may vary other provisions of the supply agreement—even without the consent of the lessor. Although Section 2A-209 of proposed Uniform Commercial Code ("U.C.C.") Article 2A (successor to the Uniform Personal Property Leasing Act) takes a somewhat more elaborate approach, perhaps the best approach here is to provide that the supply agreement, once concluded, cannot be varied without the consent of all concerned. Of course, such consent (subject to agreed limitations and standards) could be given in advance by one or more parties.
**Article 5**

**Proposed Revised Text:**

1. The lessor's [real] rights in the equipment shall be valid against the lessee's [trustee in bankruptcy and] creditors, including creditors who have obtained an attachment or execution or similar judicial process, and representatives of the lessee's creditors in insolvency proceedings, such as a trustee in bankruptcy.

2. Where by [the] **applicable law** of the State of the lessee's principal place of business the lessor's [real] rights in the equipment are valid against the parties referred to in paragraph 1 only on compliance with rules as to public notice, the lessor's [real] rights shall be valid against these parties only where they are valid according to such rules.

For the purposes of this paragraph

(a) **the applicable law is the law (including the conflict of laws rules) of the State (and any political subdivision of the State) where the equipment is located, unless the equipment is of a type normally used in more than one State, and the law (including the conflict of laws rules) of the State (and any political subdivision of the State) of the lessee's principal place of business; and**

Alternative A

(b) If the lessee has more than one place of business, the principal place of business of the lessee is the State where the chief executive office of the lessee is located.

Alternative B

(b) If the lessee has more than one place of business, the principal place of business is that which has the closest relationship to the leasing agreement and its performance, having regard to the circumstances known to or contemplated by the lessee and the lessor at any time before or at the conclusion of the leasing agreement.

[3.- The preceding paragraphs shall not apply in relation to equipment such as ships and aircraft subject to registration pursuant to an international Convention.]
3. - The preceding paragraphs shall not apply to the extent that they are inconsistent with any international Convention which deals with the registration of ownership of or liens on or security interests in equipment normally used in more than one State such as ships and aircraft.

4.- This article shall not affect the rights of any creditor of the lessee having a lien on or a security interest in the equipment, unless such lien or security interest was obtained by attachment or execution or similar judicial process or is in favor or a representative of creditors referred to in paragraph 1.

Discussion:

Article 5 presents some very difficult problems.

(i) The references in paragraphs 1 and 2 to "real" rights do not appear to us to add anything useful and may create unnecessary confusion.

(ii) The proposed addition to paragraph 1 is merely intended to clarify and amplify the meaning of "attachment or execution" and the meaning of "trustee in bankruptcy."

(iii) The issues raised by paragraph 2 are quite important. The Observations of the United States submitted to the UNIDROIT Secretariat prior to the April, 1986 meeting took exception to the result of making the law of the lessee's "principal place of business" (a term not defined in the 1985 draft or the 1986 Draft) determinative as to any requirement for public notice. Our view was, and remains, that the location of the equipment should, in many instances, be determinative. Our concerns are based on the undesirability of creating a "secret lien" on equipment located in a State the local law of which requires public notice. Our view was rejected by many of the governments represented at the meeting. The proposed revisions to paragraph 2 attempt to re-introduce the situs rule while maintaining the relevance of the lessee's principal place of business. In effect, our proposal would make the applicable law that of both the principal place of business and the situs of the equipment (except in the case of "mobile equipment", where only the law of the principal place of business would apply). If public notice were required under the law of either jurisdiction, compliance would be necessary.

In addition, alternative definitions of "principal place of business" are proposed. Alternative A is drawn substantially
from U.C.C. § 9-103(3)(a), (b) and (d). Alternative B is drawn from Article 2, paragraph 2, of the 1986 Draft and from Article 10 of the Sales Convention. Alternative A has the advantage of providing, perhaps, a somewhat less subjective test than that of Alternative B. Also, since Article 5 deals primarily with the rights of third parties, the original contemplations of the lessor and lessee are less significant. Of course, other issues remain untreated by our proposal. Examples are the effects of a change in the location of equipment or the principal place of business of a lessee. Also, it is possible (especially under Alternative A) that the principal place of business and/or the situs of the equipment will not be in Contracting States, even though the Convention might be applicable under Article 1, paragraph 1.

(iv) As drafted, paragraph 3 is ambiguous as to equipment other than ships and aircraft and fails to distinguish between registration of ownership and registration of liens. The proposed changes to paragraph 3 are intended to address these issues. Consideration should be given as to whether the issue of conflicting international conventions should be dealt with more generally in the Final Provisions of the Convention.

(v) The proposed addition to paragraph 4 is intended to address the possible conflict between the terms of paragraph 1 and paragraph 4. A creditor obtaining attachment or execution normally obtains a lien on the property seized. Paragraph 4 appears to contradict paragraph 1, therefore, by providing that the rights of creditors holding liens are not affected by Article 5. Our proposal would expressly exclude the liens of such creditors (and of a trustee in bankruptcy) from the otherwise broad sweep of paragraph 4.

Article 6

Article 6 was mentioned above in connection with proposed new paragraph 5 to Article 1. The purpose of Article 6 is a good one—to make it clear that the local law of the situs will govern matters relating to rights in fixtures. However, we believe that a change such as that provided in proposed new Article 1, paragraph 5, is necessary.

Article 7

General Comments

With all due respect, we believe that Article 7 is an example of the failure of the Committee and the Drafting Committee to appreciate a fundamental characteristic of the *sui generis*
financial leasing transaction. (Article 10, discussed below, is another example.) That characteristic is that the lessor in such transactions is essentially a supplier of money and not a supplier of goods. It is the lessee that selects the supplier and provides the specifications for the equipment. The lessor is merely providing funds and making an investment. The lessor normally will never have any possession or control of the equipment (prior to default or expiration of the lease term). The development of strict tort liability theories and the rules relating to warranties of merchantability and fitness of goods reflect the wisdom of placing responsibility for defects and quality on parties who bear some control and social responsibility for such defects and quality. The financial lessor fits into neither of these categories. The financial lessor is merely seeking a return on its investment. The financial lessor may or may not rely on the residual value of equipment at the end of the lease term, but any such reliance is a product only of an economic and investment analysis. The financial lessor does not deal in goods.

We believe that certain provisions in Articles 7 and 10 also tend to undercut the very purpose and rationale for the Convention. The Convention has been motivated by a worthy desire to create a legal regime which will accommodate the emergence of financial leasing transactions, during the last thirty or so years, as important means of capital acquisition. Therefore, the Convention must contemplate and reflect the patterns and structure of such transactions as they actually occur in commercial and financial practice. Financial leasing transactions offer a prospective user of equipment an alternative to borrowing (on secured or unsecured credit) the purchase price of the equipment. If the prospective user elects to borrow the money, the lender of funds is not expected to take any responsibility for the title to, quality of or defects in the equipment. Similarly, the lender of such funds would not be expected to assume any responsibility for the performance of the supplier of the equipment. A central purpose of the legal regime to be created by the Convention should be to demonstrate that the role of the financial lessor is, as to such matters, identical to that of the lender of funds to be used for the purchase price. This functional equivalency is effected by the terms of documents typically entered into in connection with actual financial leasing transactions. As will be mentioned below, however, the 1986 Draft represents a step backwards and away from this underlying purpose of the Convention. In several respects it fails to free the sui generis financial leasing transactions from the restrictive bonds of traditional concepts of leasing and hiring contracts not of the financial leasing variety.
Another significant and unfortunate prospect of this development is the potential for the Convention to impede and restrict, rather than promote, the availability of financial leasing transactions to lessees in developing countries. By providing the wrong signals as to the function, role and responsibilities of the financial lessor, the Convention could make financial leasing to lessees in developing countries even more risky for lessors than under the present regimes. It is clear that certain provisions in the 1986 Draft were motivated by the responsible desire (which we share) to create a legal regime which is balanced and fair to lessees. Unfortunately, we believe that the Drafting Committee failed to appreciate that this goal is largely accomplished in the scope provisions of the Convention. The Convention only applies to transactions where the lessor is not responsible for the supply or specifications of the equipment and where the lessor is the functional equivalent of a lender of funds. Lessees in financial leasing transactions seek only a means of acquiring funds for the purchase or use of equipment. They do not seek an additional party (the lessor) to bear responsibility for the supplier's performance. That is the role of a performance bond or guarantee.

It is true that under the formulation of Article 13, paragraph 2, the parties may derogate from the provisions of Articles 7 and 10. However, this is of no benefit in the case of Article 7, paragraph 1, to the extent that it relates to rights of and duties to third parties. Moreover, we believe that the Convention should reflect the norms and expectations prevailing in sui generis financial leasing transactions. It should not contradict those norms and expectations.

**Paragraph 1**

**Proposed Revised Text:**

1.- (a) Except as otherwise provided by this Convention, the lessor does not owe the lessee or third parties any duty in contract or tort merely by acting in its capacity of lessor or owner of the equipment.

(b) The preceding sub-paragraph shall not apply to the extent that the lessor has intervened in the choice of the supplier or the choice or specifications of the equipment.

[(c) The above provisions shall not affect any liability of the lessor in any other capacity, for example as owner].
DISCUSSION:

In light of the foregoing, we believe that Article 7, paragraph 1(c) should be deleted because it would undercut the effect of paragraphs 1(a) and (b). It should be the function of paragraph 1 to lay to rest the notion that the financial lessor may have some liability to third parties merely because it is an "owner" of the equipment. This prompts our proposal that the words "or owner" be added to paragraph 1(a). Because the financial lessor's function in the distributive chain is only that of a supplier of money, it should bear no responsibility for defects in the goods. Of course, when a financial leasing transaction comes to an end and the lessor no longer occupies that role with respect to the equipment, the Convention, and its exculpatory rules, should cease to apply.

The clear trend of cases in the United States is that strict tort liability under Section 402A of the Restatement (Second) of Torts is not applicable to a financial lessor. In this connection, the point was made that a Directive of the E.E.C. provides that an importer of goods for the purpose of leasing is a "producer" and therefore is liable for defects in goods as a "producer." If this is the case when a financial lessor is involved, then the Directive would not seem to reflect the commercial realities and current trends as we understand them.

We are mindful that the issues raised by our proposed changes to Article 5 were discussed in detail at the first session of the Committee and that the substance of these proposals was rejected by the Committee at that time. See Explanatory Report prepared by the UNIDROIT Secretariat, December, 1985 (Study LIX – Doc. 25), at 58-62. Moreover, we have the utmost respect and appreciation for the capabilities of other States and regional organizations to devise appropriate domestic and regional laws. However, we respectfully submit that the Convention should not be driven by existing domestic or regional laws which presently fail to appreciate the sui generis nature of the financial leasing transaction. Indeed, the failure of existing laws in many countries to appreciate this nature is one of the principal motivations for the Convention. See 1986 Draft, Preamble, Fourth Clause.

We believe that the Committee should address the issues on the merits. If imposing liability on an "owner" of goods when such "owner" has merely supplied money and has taken no social responsibility for the selection, quality, specifications, use, possession or operation of the goods represents the Committee's considered view of a proper allocation of responsibility, then we
would merely disagree with that conclusion. We do, however, strongly disagree with the notion that the Convention should be shaped by local or regional laws and rules even if the Committee does not agree with such rules on the merits.

**Paragraph 2**

**Proposed Revised Text:**

/Alternative I/

2.- The lessor warrants that the lessee's quiet possession will not be disturbed by the lawful act of a person having a superior title or right [not] derived from any act or omission of the [lessee] lessor.

/Alternative II/

2.- The lessor warrants that the lessee's quiet possession will not be disturbed by the lawful act of a person having a claim to a superior title or right where such claim is [not] derived from any act or omission of the [lessee] lessor./

**Discussion:**

Paragraph 2, Alternative I, is the formulation of the lessor's warranty of title as it read in the 1985 draft of the Convention. Alternative II was added in the 1986 Draft. Alternative I creates a near absolute lessor's warranty (excepting only adverse interests derived from the lessee's acts or omissions) of title. Alternative II goes even further -- it covers claims to superior title, even if the claims are not valid. Neither formulation is acceptable in a financial leasing transaction. The lessee selects the supplier and the lessee selects the equipment. The lessor supplies the money. Both Alternatives I and II effectively require the lessor to stand behind and vouch for the supplier's title. Thus, the lessee is acquiring not only the use of the equipment it selected, but an additional party to sue if for any reason there is a title defect. Financial lessors and lessees do not expect that the lessor will, in effect, be called upon to provide a performance bond supporting the supplier's warranties of title. The changes proposed to Alternatives I and II are intended to require the lessor to warrant only that its own actions and omissions will not result in a disturbance of the lessee's quiet possession. This conforms to the norms expressed in financial leasing documentation.
As between the two alternatives, we prefer Alternative I. Alternative II introduces the concept of a "claim" which, even if it is not rightful, results in the disturbance of the lessee's quiet possession. It would seem to be a quite remote possibility that such a non-rightful claim would arise, would result in the actual disturbance of quiet possession by a lawful act of the person having such a non-rightful claim and would be derived from an act or omission of a financial lessor (or, under the 1986 Draft formulation, not from an act or omission of the lessee). Such risks do not seem sufficiently realistic to justify inclusion of a warranty in the Convention. If a lessee insists on such protection it will have an opportunity to negotiate for an appropriate contractual provision in the leasing agreement. Of course, if the claim is rightful then it would be covered by the Article I formulation.

Article 9

Paragraph 1

Proposed Revised Text:

1. The duties of the supplier under the supply agreement shall also be owed to the lessee as if it were a party to that agreement and as if the equipment were to be supplied directly to the lessee [for its professional or business purposes].

Discussion:

We propose that the phrase "for its professional or business purposes" be deleted from the text. Since Article 9 will only be applicable to a supply agreement in a financial leasing transaction, the quoted phrase is superfluous at best. Moreover, it is susceptible to misinterpretation and is ambiguous as discussed above in connection with proposed new Article 1, paragraph 4.

Article 10

General Comments

Article 10 of the 1986 Draft and our proposed changes must be considered in light of general practices and expectations in financial leasing transactions. A financial lessor generally does not advance funds to the supplier unless the lessee is satisfied with the equipment and the lessee agrees that the lease will remain in force and the rentals will be paid notwithstanding
some later discovered nonconformity or defect. As written, paragraph 2 and each of the alternatives of paragraph 3 appear to contemplate the situation where the lessee accepts delivery of the equipment, later discovers a nonconformity and then seeks to terminate the lease and recover back sums already paid under the lease. That scenario is not characteristic of financial leasing, as mentioned above.

The financial lessor must be able to establish that, after a date certain, the lessee is obligated to pay the rentals and may raise no defense against the lessor relating to the conformity of the equipment to the terms of the supply agreement. This is normally achieved by conditioning the lessor’s obligation to pay the price to the supplier, under the supply agreement, upon delivery (and installation, if applicable) of the equipment to the lessee and the lessee’s acceptance of the equipment. The lessee normally will be required to execute an acceptance certificate acknowledging that the equipment is satisfactory and the obligations of the lessee under the financial lease are noncancelable. If a nonconformity later develops, the lessee’s remedies are against the supplier selected by the lessee, not against the lessor.

**Paragraphs 2 and 3**

**Proposed Revised Text:**

2.- The right to reject non-conforming equipment shall be exercised by notice to be given to the lessor within a reasonable time after the lessee has discovered the non-conformity or ought to have discovered it, but in any event the lessee's right to reject the equipment must be exercised prior to the lessee's acceptance of the equipment. Rejection for [non-conformity] failure of the equipment [under] to conform to the terms of the supply agreement shall not preclude a fresh tender of the same equipment or a tender of other equipment in conformity with that agreement if made within a reasonable time after notice to reject.

/Alternative I/

3.- Where the supplier fails to deliver the equipment in accordance with paragraph 1 or paragraph 2 of this article, the lessee shall, unless the lessee has accepted the equipment, be entitled to terminate the leasing agreement and to recover any rentals and other sums paid in advance. Nevertheless, the lessee shall be obliged to pay the lessor a reasonable sum for the benefit the lessee has derived from the equipment.
/Alternative II

3.- Where the supplier fails to deliver the equipment in accordance with paragraph 1 or paragraph 2 of this article, the lessee shall, unless the lessee has accepted the equipment, be entitled to exercise one or more of the following rights:

(a) to withhold or recover any rentals and other sums payable or paid;

(b) to terminate the leasing agreement.

Nevertheless, the lessee shall be obliged to pay the lessor a reasonable sum for the benefit the lessee has derived from the equipment.

Discussion:

The changes proposed in paragraphs 2 and 3 are intended to provide certainty by specifying that the lessee's "acceptance" of the equipment precludes rejection and termination by the lessee. It might be wise to include a definition of "acceptance", although our proposed changes do not do so. Under the proposed changes, it is left to the parties to agree, or a tribunal to decide, what constitutes acceptance and the time when it occurs. This puts the lessee in just as good a position as it would have enjoyed if the lessee had dealt directly with the supplier and bought the equipment. If the lessee concludes that it needs more protection, it can withhold approval of the supply agreement (thereby taking the transaction outside the scope of the Convention) unless that agreement contains terms satisfactory to protect the interests of the lessee in the event of subsequent trouble.

As between paragraph 3 Alternatives I and II, we believe that Alternative I is preferable. Alternative II contemplates the situation where the lessee will withhold payment of rentals and other sums (which could even reach indemnification obligations unrelated to the nonconformity) after delivery of the equipment. As mentioned above, this is not characteristic of financial leasing transactions.
Paragraph 5 (Proposed)

Proposed Revised Text:

5. - (a) The lessee's promises under the leasing agreement become irrevocable and independent upon the lessee's acceptance of the goods.

(b) A promise that has become irrevocable and independent under paragraph (a) is effective and enforceable between the parties and by or against third parties including assignees of the parties, and is not subject to cancellation, termination, modification, repudiation, excuse or substitution without the consent of the party to whom the promise runs.

(c) Nothing in this paragraph shall limit or preclude any claim which the lessee may have against the lessor which is preserved under paragraph (4).

Discussion:

Proposed new paragraph 5 is derived from proposed U.C.C. Article 2A § 2A-407 which applies only to "finance leases." ("Finance lease" is defined in Article 2A so as to cover only leases in the nature of the financial leasing transactions to be covered by the Convention.) Paragraph 5 is a corollary of the proposed changes to paragraphs 2 and 3, discussed above. After the lessee accepts the equipment, the obligations of the lessee are irrevocable and independent. Again, the rule of paragraph 5 is characteristic of financial leasing transactions which necessarily involve a lessor which plays a role functionally equivalent to that of a lender of funds.

Article 11

General Comments

Article 11 generally improves the provisions dealing with a lessor's remedies and damages which were contained in Article 12 of the 1985 draft rules. However, as discussed below, we believe that some problems remain.

A fair measure of damages to a lessor which has taken possession of the equipment after the lessee's default would be that the lessor could recover (i) the unpaid accrued rentals plus (ii) the present value of future rentals less (iii) the fair market value of the use of the equipment for the remainder of the lease term. Item (iii) represents mitigation of damages because
the lessee is being deprived of the use of the equipment for which the lessee is required to make payment under item (ii). The lessor should not be entitled to both the equipment and future rentals, which would provide a double recovery, unless some element of mitigation is provided. In other words, the lessee must be credited with the use value of the equipment if it has been deprived of possession. Although paragraph 2 does not spell out the measure of damages in such detail, we believe that it will fairly accommodate such a reasonable measure of damages.

**Paragraphs 3 and 4**

**Proposed Revised Text:**

3.- The leasing agreement may provide for the manner in which the compensation referred to in paragraph 2 (b) of this article is to be computed and such provision shall be enforceable between the parties unless such compensation is disproportionate to the compensation provided for under paragraph 2(b). **Notwithstanding paragraph 4 of this Article, the value of future rentals under the leasing agreement may be taken into account in computing compensation under paragraph 2(b) of this Article and under this paragraph.**

4.- Where the lessor has terminated the leasing agreement and recovered possession of the equipment, it shall not be entitled to enforce a term of the leasing agreement accelerating payment of the rentals.

**Discussion:**

Paragraphs 3 and 4 are troublesome primarily because of the use of the concept of "termination." A lessor might properly desire to terminate the lessee's right to possession and use under the leasing agreement upon the lessee's default. However, the leasing agreement itself should not necessarily be terminated. For example, the leasing contract may require the lessee to pay damages for breach and to continue to bear indemnification obligations. Such obligations should survive termination. Paragraph 2 appropriately recognizes that the lessor may recover damages after termination. Similarly, paragraph 3 recognizes that a "liquidated damages" provision in the leasing agreement may be employed by the parties to measure the damages recoverable under paragraph 2(b). However, paragraph 4 creates an ambiguity. As noted above in our general comments to Article 11, the present value of future rentals may be an appropriate element of the lessor's damages. The lessor should not be prevented from recovering damages intended to make it whole for the lessee's
breach merely because the lessor has taken the prudent steps of terminating the lease and taking possession of the equipment in order to protect its investment. Paragraph 4, as drafted, might be read to prevent the lessee's measure of damages from taking into account the future rental stream. The proposed addition to paragraph 3 is intended to avoid such an unreasonable construction of paragraph 4.

Another, perhaps preferable, solution would be to eliminate paragraph 4 altogether. The ambiguous concept of termination adds little and the mitigation concept built into paragraph 2(b) would seem to solve the problem addressed by paragraph 4.

The proposed change to paragraph 4 is intended to re-introduce the concept included in the 1985 draft which was deleted in the 1986 Draft. The purpose of prohibiting the lessor from recovering accelerated rentals is to avoid the possibility of the lessor's obtaining a double recovery (i.e., recovering possession of the equipment and recovering future rentals). But where the lessee remains in possession of the equipment wrongfully after a termination, the lessee should be able to accelerate the future rentals. This approach is analogous to a seller's recovery of the price for accepted goods. If the lessee pays the accelerated rentals, of course, the lessee would be entitled to what it paid for -- possession and use of the goods for the lease term. Therefore, a termination should not deprive the lessor of such a recovery unless the lessor has recovered possession of the equipment. This underscores, perhaps, the point made above that the concept of termination in the context of lease remedies and damages is not particularly useful.

**Note: Leases Intended as Security Under the U.C.C.: Debtor's Equity of Redemption**

A further issue raised by Article 11 may be peculiar to the United States. Under the U.C.C. certain transactions denominated as leases of personal property are treated as secured transactions subject to U.C.C. Article 9. U.C.C. § 1-201(37) defines the term "security interest" to include leases "intended as security." A lease which creates a security interest is treated like any other secured transaction under Article 9. Part 5 of Article 9 deals with the rights and remedies of secured parties and the rights of debtors after default. Central to the operation of Part 5 are provisions intended to protect a debtor's equity of redemption in the collateral (here, the "leased" equipment). In a true lease, on the other hand, a lessee has no such equity of redemption because it is the lessor which is entitled to the residual or reversionary interest in the equipment.
Article 11 embodies remedies and measures of damages which are generally appropriate for true lease transactions in the United States but which would not be appropriate for secured transactions under the U.C.C. However, the scope provisions of the Convention (Articles 1 and 3) do not appear to limit the Convention's scope to transactions which would be true leases. Rather, they appear to cover also leases which are intended as security (under the U.C.C.). Therefore, assuming that the Convention would override local law (the U.C.C.) in the United States, which is one of its central purposes, a United States lessee might be disadvantaged under the Convention.

Notwithstanding the foregoing, we do not propose that any special treatment be provided in the Convention for leases intended as security under the U.C.C. It might be perceived as unfair for us to insist upon preferential treatment for United States lessees and special accommodation for United States local law. It is true that we have already made one such proposal in connection with the potential "secret lien" issue under Article 5. However, the public notice issue is one which involves third parties and is not susceptible of resolution in the leasing agreement. In contrast, protection of a lessee's equity of redemption and other rights on default are matters which can be dealt with in the leasing agreement and may be negotiated by a United States lessee. Since it is a fair assumption that many international financial leasing transactions will be subject to input from lawyers for the parties and will be the subject of negotiation, a United States lessee should be in a position to protect itself.

Article 13

The Observations of the United States submitted to the UNIDROIT Secretariat prior to the April, 1986 meeting expressed the view that "[t]he right to opt out of most of [the Convention's] provisions should be carefully limited to avoid unfair use of economic power." While we remain of that view, it is apparent that it may require adjustment based on the substance of the rules of the Convention which ultimately emerge.

In general, we are of the view at this time that the provisions from which the parties are free to derogate as specified in paragraph 2 are satisfactory. However, the right of the parties to opt out of the entire Convention deserves more thought and attention. In this connection, we note that Article 6 of the Sales Convention provides to the parties complete freedom to exclude the applicability of the entire Convention as well as the ability to "derogate from or vary the effect of any of its
provisions." The interest of obtaining a useful and mandatorily applicable legal regime for international financial leasing transactions must be balanced against the desires and needs of parties to elect the applicability of existing legal regimes where the parties deem them to be satisfactory.
APPENDIX

to the

OBSERVATIONS AND PROPOSALS
OF THE UNITED STATES OF AMERICA

International Institute for the
Unification of Private Law:
Draft Convention on International Financial
Leasing as Proposed by the Drafting Committee at the
Meeting of the Committee of Governmental Experts,
Second Session, 14 - 18 April, 1986, Rome, Italy

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